

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Monteith Analyst: Roger Lackey Bill Number: SB 1521

Related Bills: None Telephone: 845-3627 Introduced Date: 02-17-00

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Agricultural Water Filtering Systems & Equipment Deduction

SUMMARY

This bill would allow a taxpayer to expense as a deduction any costs paid or incurred during the taxable or income year for the construction or purchase of systems and equipment used to prevent contaminated agricultural waters from entering public waterways or underground aquifers.

EFFECTIVE/OPERATIVE DATE

This bill would take effect upon enactment and apply to taxable or income years beginning on or after January 1, 2000.

SPECIFIC FINDINGS

Current state and federal laws generally allow taxpayers engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business, including purchases of systems and equipment. However, purchases of property with a useful life in excess of a year, such as vehicles, major equipment, and buildings, must be depreciated over several years rather than deducted in the year purchased.

Current state and federal tax law treat certain business entities, i.e., corporations, trusts, and associations, as taxable entities where the tax is imposed on income received by the entity. Other business entities such as partnerships are pass-through entities where the income of the entity is not taxed at the entity level. Instead tax is imposed on the owners of the pass-through entity on their proportionate or distributive shares of the entity's income. While federal law and state law provide that "S" corporation income is passed through and taxed to the shareholders, current state law also subjects an "S" corporation to a 1.5% tax on its income.

Generally, any election affecting the computation of taxable income derived from a pass-through entity is made by the entity. In addition, an owner of a pass-through entity is considered to have incurred income, deductions, etc. from the same source or in the same manner as the pass-through entity.

In determining a partner's income tax, each partner is required to take into account the partner's distributive share of partnership income, gain, loss, deductions, and credits. A partner's distributive share of income, gain, loss, deduction, or credit is determined in accordance with the partnership agreement, so long as the allocation pursuant to the agreement has substantial economic effect.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Alan Hunter for GHG

4/5/00

If an allocation pursuant to the partnership agreement does not have substantial economic effect, then such allocation shall be in accordance with the partner's interest in the partnership.

In determining the income tax of a shareholder of an "S" corporation, the shareholder is required to take into account the shareholder's pro rata share of the corporation's income, loss, deductions, or credit. A shareholder's pro rata share of the income, loss, deduction or credit of an "S" corporation is equal to the sum of the amounts determined for each shareholder by assigning an equal portion of each item to each day of the taxable year and then dividing that portion pro rata among the shares outstanding on that day.

This bill would allow a taxpayer engaged in an agricultural business (as defined) to elect to expense as a deduction any costs paid or incurred during the taxable or income year for the construction or purchase, or both, of systems and equipment used to prevent contaminated agricultural waters from entering public waterways or underground aquifers.

This bill would provide that if an agricultural business is owned by more than one taxpayer, each taxpayer may deduct that portion of the costs paid or incurred with respect to the water filtering systems and equipment proportionate to the taxpayer's interest in the business.

The deduction would only apply to agricultural water filter systems and equipment placed in service in California.

This bill would define the terms "agricultural water filter system and equipment," "contaminated agricultural waters," and "qualified taxpayer."

Policy Considerations

Current state and federal laws require businesses and individuals to minimize pollution from their businesses and other activities. This bill would allow a deduction for the construction or purchase of systems and equipment used to prevent contaminated agricultural water from entering public waterways. It's unclear what incentive this bill would provide since under current state and federal law, these entities are already required to prevent and limit the pollution of public waterways by their activities and businesses.

Current state and federal law does not allow a corporation (other than an "S" corporation) to pass through items of expense or income to its shareholders. However, since the B&CT provisions of this bill duplicate those under PITL, it would permit the deduction for costs paid or incurred by a corporation with respect to agricultural water filter systems and equipment to be passed through to B&CT shareholders in proportion to the shareholders' interest in the business. It is unclear whether this is the author's intent.

Current federal and state laws allow taxpayers to elect to deduct certain expenses normally chargeable to capital account. However, these deductions are subject to specified dollar limits. The deduction allowed by this bill is unlimited.

Implementation Considerations

It is unclear when the "agricultural water filter system and equipment" constructed or purchased by the taxpayer would be required to satisfy the requirement to prevent or assist in preventing contaminated water from entering public waterways or underground aquifers.

Current law specifies that the allocation of income, deductions, credits, etc., for partnerships and "S" corporations shall be on the basis of a partner's distributive share pursuant to a partnership agreement or an "S" corporation shareholder's pro rata share. This bill provides that the deduction allowed by the bill shall be allocated in accordance with the interest of each owner in an agricultural business. However, the bill does provide a basis (such as profits interest, capital interests, etc.) for determining owner interests.

The election provided by this bill is presumed to be in lieu of any depreciation deduction. However, the bill does not affirmatively eliminate a depreciation deduction because it does not specifically require that the taxpayer's basis in the subject property be reduced by the amount of the deduction. To clarify, the author should amend bill to make the election "in lieu of expenses chargeable to capital account."

Once the implementation concerns are resolved, implementing this bill would not significantly impact the department's programs and operations.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue impact of this measure, under the assumptions discussed below, is estimated to be as follows:

Revenue Impact of the Proposal Income/Taxable Years Beginning On or After 1/1/2000 (In Millions)			
	2000-1	2001-2	2002-3
Revenue Impact	(\$4)	(\$4)	(\$4)

This analysis does not account for changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The estimates below are based largely on information through contacts with California experts in water/agriculture industry. This information indicates that no complete systems or equipment to filter or isolate the contaminated water are available for purchase.

General, systems are constructed to direct contaminated water to a specific place. This may be accomplished through drainage pipes or tiling, with plastic sheets in the ground to divert the water flow. The drained water is then pumped to evaporation ponds.

A number of factors affect costs, such as soil condition and the type of contaminant. For example, when the texture of soil is fine, it becomes easier to direct surface water since it does not penetrate underground easily. Based on discussions with industry experts, it was assumed that the average cost per acre is \$500. About 35% to 40% of acreage in California could benefit from this proposal based on soil conditions, including San Joaquin Valley, Imperial Valley, and Sacramento County.

For this analysis it was assumed that to comply with federal and state laws, about 40% of California irrigated land (9 million acres) have a filtering system already in place. A double-declining depreciation method was used to calculate deductions under current law assuming 18 years of depreciable life for a typical system. As a result, 1/18 of a typical system is assumed to be replaced each year. Revenue impacts were calculated on the basis of the deductions generated to replace the existing systems under the current and proposed law.

BOARD POSITION

Pending.

